



BITCOINS - VIRTUAL CURRENCY

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BITCOINS

- Bitcoins is a form of virtual currency. "Bitcoin" (capitalized), refers to the technology and network; "bitcoins" (lower case), refers to the currency itself.
- The U.S. Treasury Department has published guidelines explaining how the federal Bank Secrecy Act and its implementing regulations apply to certain virtual currency activities.
- The Government Accountability Office has concluded that the use of virtual currencies could produce taxable income.
- New York and California are considering using licensing requirements as a way to regulate virtual currency activities.
- California has introduced a bill that allows the use of alternative currency.

QUESTION

Provide a summary of (1) the use of bitcoins as virtual currency, (2) the laws that govern it, and (3) other states' attempts to regulate it.

SUMMARY

Bitcoins is a form of virtual currency, created in 2009 by a computer programmer using technology that allows financial transactions to be conducted on a network using computer codes.

There are no state or federal laws that specifically govern bitcoins.

The U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) provided guidance indicating that, under federal law, a virtual currency "user" is not a "money transmitter" and is therefore not subject to the registration, reporting, and recordkeeping regulations for money services businesses (MSBs). However, virtual currency "administrators" and "exchangers" may be regulated as money transmitters, but should not be considered "dealers in foreign exchange."

The Government Accountability Office (GAO) issued a report to the U.S. Senate in which it concluded that a taxpayer who receives virtual currency as payment for real goods or services could earn taxable income. The GAO has urged the Internal Revenue Service (IRS) to issue guidance.

New York is considering requiring a “BitLicense” for businesses that conduct transactions in virtual currencies, such as bitcoins. California, on the other hand, is looking into whether the licensing requirement of the California Money Transmission Act applies to virtual currency companies. Also, the California General Assembly has introduced a bill that allows the use of certain alternative currencies as lawful money, but does not require anyone to accept them.

BITCOINS

What is it?

Bitcoins is a form of virtual currency. It is a form of exchange that operates like a currency but does not have all the attributes of real currency. FinCEN promulgated regulations that define real “currency” as the coin and paper money of the United States or of any other country that:

1. is designated as legal tender,
2. circulates, and
3. is customarily used and accepted as a medium of exchange in the country where it is issued (31 CFR § 1010.100(m)).

No country has designated bitcoins as legal tender, therefore, it does not meet the definition of real currency.

Some countries have made announcements regarding Bitcoin. Australia, Canada, Finland, and Germany say that normal earned income rules apply to Bitcoin. In China, exchanging bitcoins for local currency is restricted. The securities regulator for Brazil recently ordered a Bitcoin company to suspend what the regulator described as an investment fund. Denmark has stated that future regulations may be imposed.

How did it originate?

A computer programmer created Bitcoin in 2009 as a way to issue and transfer virtual currency across the internet, using software that is open to everyone for participation.

How does it operate?

Bitcoins are created as virtual currency on a network through a process called “mining.” This is a process in which a person (1) installs the bitcoin mining software on his or her computer or mobile device, (2) solves a complex equation, and (3) receives a block of 25 bitcoins. Bitcoins come in the form of a unique string of alphanumeric characters, known as the bitcoin address. The bitcoin address

contains two uniquely related cryptographic keys (basically long random numbers), "private key" and "public key." The private key is saved in a virtual wallet and is known only to the bitcoin owner, who uses the private key to conduct a transaction. The public key associated with the bitcoin address is public information and is used to verify the transaction. By Bitcoin's program design, there will be a maximum of 21 million bitcoins in circulation once all bitcoins have been mined, which the program's design projects to be in the year 2140 ([May 2013 GAO – Report](#)).

Users can also acquire bitcoins already in circulation by purchasing them or accepting them as gifts or payments for good or services. Users conduct Bitcoin transactions by sending digitally signed messages to the network. A message to the network to make a payment using bitcoins must contain the alphanumeric address (the code) from the public key and a digital signature that proves that the person also has possession of the corresponding private key. All the bitcoins that are sent to a particular address can be spent by anyone who has the corresponding private key. If a private key is lost, the bitcoins associated with that key cannot be recovered.

A critical part of the Bitcoin network is a public database known as a "block chain." The block chain keeps a record of all transactions and tracks current and past bitcoins owners. Transactions are conducted anonymously; owners of bitcoins are identified by Bitcoin addresses, not names or other personal information. The people who verify transactions and maintain the block chain (the public database) are "miners," who are compensated with transaction fees and newly issued bitcoins.

Bitcoins can be bought and sold on Bitcoin exchanges where they are priced against the value of other currencies. Additionally, bitcoin ATMs allow users to convert cash into Bitcoins or bitcoins into cash. On February 20, 2014, *USA Today* reported that the first Bitcoin ATM in the USA was unveiled in Austin Texas with reports of others in Boston and Albuquerque ([USA Today – "Bitcoin ATMs come to USA"](#)).

FEDERAL LAWS AND GUIDELINES THAT APPLY TO BITCOINS

There are no laws that specifically govern bitcoins. However, on March 18, 2013, FinCEN, under its authority to administer the Bank Secrecy Act (BSA), issued guidance on how it characterizes certain activities involving virtual currencies under the BSA and FinCEN regulations ([FIN-2013-G001](#)). The FinCEN guidance addresses "convertible" virtual currency, which is the type of virtual currency that has an equivalent value in real currency or acts as a substitute for real currency.

The FinCEN guidance establishes whether the registration, reporting, and recordkeeping requirements for money services businesses (MSBs) apply to persons engaged in virtual currency activities (31 CFR § 1010.100(ff)).

FinCEN categorizes persons engaged in virtual currency activities as “administrators,” “users,” or “exchangers,” and defines these terms as follows:

1. “Administrators” are persons engaged in the business of issuing and redeeming virtual currency.
2. “Users” are people who obtain virtual currency to purchase goods or services.
3. “Exchangers” are persons who are in the business of exchanging virtual currency for real currency, funds, or other virtual currency ([FIN-2013-G001](#)).

Virtual Currency Users

According to FinCEN’s guidance, a user who obtains convertible virtual currency and uses it to purchase real or virtual goods or services is not an MSB because the activity does not fit within the definition of “money transmission services” and is therefore not subject to FinCEN’s registration, reporting, and recordkeeping regulations for MSBs. The term “money transmission services” means the acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means (31 CFR § 1010.100(ff)(5)(i)(A)).

Virtual Currency Administrators and Exchangers

Based on FinCEN’s guidance, an administrator or exchanger that (1) accepts and transmits a convertible virtual currency or (2) buys or sells convertible virtual currency for any reason is a money transmitter, unless specifically exempt. FinCEN’s regulations define the term “money transmitter” as a person that provides money transmission services, or any other person engaged in the transfer of funds (31 CFR §§ 1010.100(ff)(5)(ii)(A)-(F)).

Accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the regulations because the definition of a money transmitter does not differentiate between real and convertible virtual currencies.

FinCEN includes in its guidance the appropriate regulatory treatment of administrators and exchangers of virtual currency under different scenarios.

Dealers in Foreign Exchange

FinCEN does not consider a person who accepts real currency in exchange for virtual currency, or vice versa, as a “dealer in foreign exchange” because virtual currency is not the currency of any country and under FinCEN regulations, a person must exchange the currency of two or more countries to be considered a dealer in foreign exchange (31 CFR § 1010.100(ff)(1)).

Government Accountability Office Report

In May 2013, the GAO issued a report to the U.S. Senate stating that using virtual currencies may produce taxable income depending on whether the transaction takes place in a “closed-flow” or an “open-flow” virtual currency system ([May 2013 GAO – Report](#)). According to the GAO report, a person who receives virtual currency as payment for real goods or services (i.e., an “open-flow” system), may have earned taxable income because the virtual currency can be exchanged for (1) real goods or services or (2) government issued currency. However, when virtual currency is limited to the purchase of virtual goods or services (i.e., a “closed-flow” system), taxable income is not produced.

The GAO recommends that the IRS provide information to taxpayers on the tax reporting requirements for virtual currencies.

OTHER STATES’ ATTEMPTS TO REGULATE BITCOINS

The regulation of virtual currencies has implications for many areas of law, including taxation, labor, campaign finance, and money laundering. New York and California have been considering ways to regulate bitcoins.

New York

The New York State Department of Financial Services held a two-day public hearing on virtual-currency regulation on January 28, 2014 and January 29, 2014. The hearing covered a potential new financial services license, termed a “BitLicense,” for businesses handling transactions in virtual currencies such as bitcoins.

California

California is looking into whether the licensing requirement of the California Money Transmission Act applies to virtual currency companies. Additionally, the California General Assembly has introduced a bill ([AB-129](#)) that amends the Corporations Code, relating to business associations. The bill specifies that the issuance and use of alternative currency that is redeemable for lawful money of the United States or

that has value based on the value of lawful money of the United States is not prohibited. The bill, however, also specifies that no one is required to accept alternative currency. This bill was last amended on January 23, 2014.

HYPERLINKS

California Assembly Bill 129, "An act to amend Section 107 of the Corporations Code, relating to business associations," Retrieved on February 28, 2014 from http://www.leginfo.ca.gov/pub/13-14/bill/asm/ab_0101-0150/ab_129_bill_20140123_amended_asm_v96.pdf

GAO, *Virtual Economies and Currencies*, May 2013, Retrieved on February 28, 2014 from <http://www.gao.gov/assets/660/654620.pdf>.

U.S. Department of the Treasury, Financial Crimes Enforcement Network, FIN-2013-G001, "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies," Retrieved on February 28, 2014 from http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf

USA Today, "Bitcoin ATMs come to USA," Retrieved on February 28, 2014 from <http://www.usatoday.com/story/money/business/2014/02/19/bitcoin-atm-austin/5623387/>

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